

ORIGINAL



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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson *EA for EGT*
Director
Utilities Division

DATE: September 7, 2007

RE: STAFF REPORT FOR THE PINE WATER COMPANY, INC. APPLICATION FOR APPROVAL TO ENCUMBER A PART OF PLANT AND SYSTEM PURSUANT TO A.R.S. § 40-285(A); AND ISSUE EVIDENCE OF INDEBTEDNESS PURSUANT TO A.R.S. § 40-302(A) (DOCKET NO. W-03512A-07-0362)

Attached is the Staff Report for the Pine Water Company, Inc. application for approval to encumber a part of plant and system pursuant to A.R.S. § 40-285(A); and issue evidence of indebtedness pursuant to A.R.S. § 40-302(A). Staff recommends approval of the requested financing authorization.

Any party to this procedure who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before September 21, 2007.

EGJ:PMC:red

Originator: Pedro M. Chaves

Attachment: Original and fourteen copies

Arizona Corporation Commission
DOCKETED

SEP -7 2007

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AZ CORP COMMISSION
DOCKET CONTROL

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Service List for: PINE WATER COMPANY, INC.
Docket No. W-03512A-07-0362

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

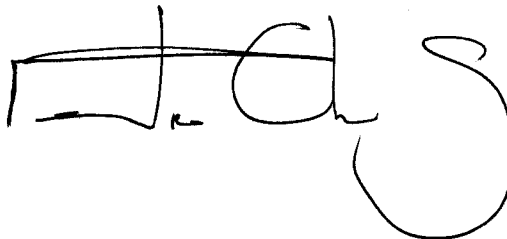
**PINE WATER COMPANY, INC.
DOCKET NO. W-03512A-07-0362**

**APPLICATION FOR APPROVAL TO
ENCUMBER A PART OF PLANT AND SYSTEM
PURSUANT TO A.R.S. § 40-285(A); AND
ISSUE EVIDENCE OF INDEBTEDNESS
PURSUANT TO A.R.S. § 40-302(A)**

SEPTEMBER 7, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for Pine Water Company, Inc. Docket No. W-03512A-07-0362 is the responsibility of the Staff members listed below: Pedro M. Chaves is responsible for the review and financial analysis of the Company's application. Marlin Scott Jr. is responsible for the engineering analysis.

A handwritten signature in black ink, appearing to read 'P. Chaves', with a large, stylized 'S' at the end.

PEDRO M. CHAVES
PUBLIC UTILITIES ANALYST II

A handwritten signature in black ink, appearing to read 'Marlin Scott Jr.', with a large, stylized 'S' at the end.

MARLIN SCOTT JR.
UTILITIES ENGINEER

**EXECUTIVE SUMMARY
PINE WATER COMPANY, INC.
DOCKET NO. W-03512A-07-0362**

Pine Water Company, Inc. ("Pine Water" or "Company"), a Class "C" Arizona public service corporation organized under subchapter "C" of the United States Treasury regulations, entered into a Joint Well Development Agreement ("Agreement") with the Pine-Strawberry Water Improvement District ("PSWID" or "District") on May 1, 2007.

The Agreement attempts to join Pine Water and District resources to address the water supply shortages in the Pine-Strawberry, Arizona region. After extensive research and analysis from the District an existing site in eastern Strawberry, Arizona ("K2 Site") showed to be suitable for further investigation and development as a possible source of water for Pine Water customers and for the benefit of landowners in the District within the certificated area of Pine Water and Strawberry Water Company, Inc.

Pine Water and the District agreed to drill and equip a deep well capable of producing a sustainable yield of no less than 150 gallons per minute ("gpm") on a portion of the K2 site and to interconnect the well to Pine Water's system ("K2 Well Project"). In order to determine whether the K2 Well is capable of producing the minimum sustainable yield, Pine Water and the District will drill a test well at the K2 site.

The estimated cost of drilling the test well is \$300,000. The District will provide the \$300,000 as up-front capital investment. In the event that the test well shows that the K2 Well Project will be able to produce a sustainable yield of 150 gpm, Pine Water has agreed to repay the \$300,000 in 36 equal monthly payments at an interest rate of 6 percent per annum to the District. In addition, Pine Water will finance the remaining costs of the K2 Well Project, estimated at an additional \$981,700. Furthermore, Pine Water will encumber its assets pertaining to the K2 Well Project to the District as collateral for the \$300,000 loan.

On June 11, 2007, the Company filed an application with the Arizona Corporation Commission ("Commission") for approval to encumber a part of plant and system and issue evidence of indebtedness pursuant to the Agreement.

At December 31, 2006, Pine Water's capital structure consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, and 100 percent equity. Staff calculated a pro forma capital structure for the Company composed of 7.1 percent short-term debt, 15.6 percent long-term debt and 77.3 percent equity that reflects a \$300,000 loan and a paid-in-capital investment of \$981,700.

Staff's pro forma TIER and DSC ratios reflecting a three-year \$300,000 loan at 6 percent and a paid-in-capital investment of \$981,700 are 13.79 and 2.41, respectively. The DSC results show that cash flow from operations is sufficient to cover all obligations.

Staff concludes that the benefit of obtaining \$300,000 to drill a test well as a contingent debt obligation exceeds the potential detrimental effect on its capital structure and financial risk.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within Pine Water's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide service.

Staff recommends that the Commission authorize Pine Water's request to borrow an amount not to exceed \$300,000 in new funds from PWSID for the purposes described herein.

Staff recommends that the Commission authorize Pine Water's request to encumber its assets related to the K2 Well Project in an amount not to exceed \$300,000 as collateral for the \$300,000 loan.

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Introduction

On May 1, 2007, Pine Water Company, Inc. ("Pine Water" or "Company") entered into a Joint Well Development Agreement ("Agreement") with the Pine-Strawberry Water Improvement District ("PSWID" or "District")¹.

The Agreement attempts to join Pine Water and District resources to address the water supply shortages in the Pine-Strawberry, Arizona region. After extensive research and analysis from the District an existing site in eastern Strawberry, Arizona ("K2 Site") showed to be suitable for further investigation and development as a possible source of water for Pine Water customers and for the benefit of landowners in the District within the certificated area of Pine Water and Strawberry Water Company, Inc ("Strawberry Water")².

Some portions of the Agreement are limited to Commission approval, pursuant to A.R.S. §§ 40-285(A) and 40-302(A)³.

On June 11, 2007, the Company filed an application with the Arizona Corporation Commission ("Commission") for approval to encumber a part of plant and system and issue evidence of indebtedness, pursuant to the Agreement.

Background

Pine Water is a Class "C" Arizona public service corporation organized under subchapter "C" of the United States Treasury regulations. The Company is primarily engaged in the business of providing water utility service to approximately 2,000 customers in its certificated area in Northern Gila County, Arizona.

The Company is a wholly-owned subsidiary of Brooke Utilities, Inc. ("Brooke Utilities"). Brooke Utilities' principal business office is located at Bakersfield, California.

Public Notice

On August 2, 2007, the Company filed an affidavit of publication verifying public notice of its financing application. Pine Water published notice of its financing application in the *Payson Roundup* on July 17, 2007. The *Payson Roundup* is a newspaper of general circulation in the county of Gila, Arizona. The affidavit of publication is attached along with a copy of the Notice.

¹ PSWID is a political subdivision of the State of Arizona and hence, is not subject to Commission regulation. See further, A.R.S. §40-909(A) (6).

² Strawberry Water is a wholly-owned subsidiary of Brooke Utilities, Inc. and hence, an affiliate of Pine Water.

³ See further, sections 4 and 5 of the Agreement.

Purpose of the Requested Financing

Pine Water and the District agreed to drill and equip a deep well capable of producing a sustainable yield of no less than 150 gallons per minute ("gpm") on a portion of the K2 Site and to interconnect the well to Pine Water's system ("K2 Well Project")⁴. In order to determine whether the K2 Well is capable of producing the minimum sustainable yield, Pine Water and the District will drill a test well at the K2 site. The purpose of the \$300,000 debt financing and related encumbrance of assets is to fund the cost to drill the test well.

Description of the Requested Financing

The District will provide the \$300,000 as up-front capital to finance the cost of drilling the test well. Under the terms of the Agreement, Pine Water is responsible for repayment of the \$300,000 up-front capital in 36 equal monthly payments at an interest rate of 6 percent per annum to the District contingent upon the test well showing that the K2 Well Project will be able to produce a sustainable yield of 150 gpm. In addition, Pine Water will finance the remaining costs of the K2 Well Project, estimated at an additional \$981,700⁵. Furthermore, Pine Water will encumber its assets pertaining to the K2 Well Project to the District as collateral for the \$300,000 loan.

Financial Analysis

Staff's analysis is illustrated on Schedule PMC-1. Column [A] reflects Pine Water's historical financial information for the year ended December 31, 2006. Column [B] presents pro forma financial information that modifies Column [A] to reflect a three-year \$300,000 loan at 6 percent per annum and a paid-in-capital investment of \$981,700.

TIER and DSC

Times interest earned ratio ("TIER") represents the number of times earnings cover interest expense on short-term and long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long-term but does not mean that debt obligations cannot be met in the short-term.

Debt service coverage ratio ("DSC") represents the number of times internally generated cash will cover required principal and interest payments on short-term and long-term debt. A DSC greater than 1.0 indicates that cash flow from operations is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default.

⁴ The K2 Well Project is estimated to cost a total of \$1,281,700 (per the Company's response to Staff's second set of Data Requests), inclusive of \$300,000 related to the test well.

⁵ Pine Water anticipates financing the remaining costs through paid-in-capital.

Schedule PMC-1, Column [A] shows that for the year ended December 31, 2006, Pine Water had no outstanding loans, hence, TIER, and DSC results are not meaningful. The pro forma results reflect a 13.79 TIER and a 2.41 DSC under the scenario described above for Column [B].

As seen in Column [B], Pine Water has satisfactory pro forma TIER and DSC results. The Company's TIER results reflect that operating income would suffice to cover interest expense in the short-term. DSC results indicate that Pine Water will be able to meet all obligations with cash generated from operations.

Capital Structure

At December 31, 2006, Pine Water's capital structure consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, and 100 percent equity (Schedule PMC-1, Column [A], lines 17-25). Inclusion of the requested \$300,000 combined with a paid-in-capital investment of \$981,000 would result in a capital structure composed of 7.1 percent short-term debt, 15.6 percent long-term debt and 77.3 percent equity (Schedule PMC-1, Column [B], lines 17-25).

Capital Structure inclusive of AIAC and CIAC

At December 31, 2006, Pine Water's capital structure, inclusive of Advances In Aid of Construction ("AIAC") and Contributions In Aid of Construction ("CIAC"), consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, 9.9 percent equity, 2.9 percent AIAC and 87.2 percent CIAC (Schedule PMC-1, Column [A], lines 28-40).

Pine Water is currently heavily invested through CIAC. The current balance of equity is \$41,575. In contrast, the current balance of CIAC is \$366,576. In this scenario, AIAC and CIAC funding represents 90.1 percent of total capital, inclusive of AIAC and CIAC. Staff typically recommends that combined AIAC and Net CIAC funding not exceed 30 percent of total capital, inclusive of AIAC and Net CIAC, for private and investor owned utilities. Furthermore, for a utility with access to the capital markets, Staff typically recommends a capital structure with a minimum of 40 percent equity of total capital (short-term debt, long-term debt and common equity) as appropriate to provide a balance of cost and financial risk. Absent access to the capital markets, a privately owned for-profit regulated utility should minimize debt and incur debt primarily as a last resort.

Inclusion of the requested \$300,000 debt combined with a paid-in-capital investment of \$981,000 would result in a capital structure composed of 5.5 percent short-term debt, 12.1 percent long-term debt, 60.1 percent equity, 0.7 percent AIAC and 21.5 percent CIAC (Schedule PMC-1, Column [B], lines 28-40). In this scenario, AIAC and Net CIAC funding represents 22.2 percent of total capital, inclusive of AIAC and Net CIAC, which is below the maximum limit typically recommended by Staff.

Engineering Analysis

According to the Company, the K2 Well Project is estimated to cost between \$1,000,000 and \$1,300,000. Through a data request response by the Company, Staff was provided budgetary estimates with a cost breakdown of this project as follows:

<u>Plant Items</u>	<u>Costs</u>
a. Land, 30 feet by 30 feet	\$ 0
b. Well drilling and casing, 1,700 feet	\$607,000
c. Well pump	\$ 40,000
d. Storage tanks, size and number of tanks	\$200,000
e. Booster system	\$ 0
f. Piping	\$ 18,000
g. Electrical power drop	\$ 16,000
h. Electrical work and controls	\$ 7,700
i. Structures	\$ 55,000
j. Hydrogeological study	\$ 8,000
k. Engineering	\$ 30,000
l. Other – Test Well	\$300,000

Total:	\$1,281,700

Staff has reviewed the K2 Well Project cost and finds the Company's budgetary estimate of \$1,281,700 to be reasonable.

Compliance

There are no compliance issues with Pine Water Company Inc.

Conclusion and Recommendations

Staff concludes that the benefit of obtaining \$300,000 to drill a test well as a contingent debt obligation exceeds the potential detrimental effect on its capital structure and financial risk.

Staff concludes that indebtedness for the amount of \$300,000 is within Pine Water's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize Pine Water's request to borrow \$300,000 from the District for the purposes described herein.

Staff recommends that the Commission authorize Pine Water's request to encumber its assets related to the K2 Well Project in an amount not to exceed \$300,000 as collateral for the \$300,000 loan.

Staff recommends authorizing Pine Water to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.

Staff further recommends that one copy of the executed loan documents be filed with Docket Control within 60 days of execution.

FINANCIAL ANALYSIS

Selected Financial Information

		[A] ¹ 12/31/2006		[B] ² Pro Forma	
1	Operating Income	\$	212,853	\$	212,853
2	Depreciation & Amort.		51,571		51,571
3	Income Tax Expense		0		0
4					
5	Interest Expense		0		15,441
6	Repayment of Principal		0		94,078
7					
8					
9	TIER				
10	[1+3] ÷ [5]		N/M ³		13.79
11	DSC				
12	[1+2+3] ÷ [5+6]		N/M		2.41
13					
14					
15					
16					
17	Capital Structure				
18					
19	Short-term Debt		0 0.0%	94,078	7.1% ⁴
20					
21	Long-term Debt		0 0.0%	205,922	15.6%
22					
23	Common Equity		41,575 100.0%	1,023,275	77.3%
24					
25	Total Capital	\$	41,575 100.0%	\$ 1,323,275	100.0%
26					
27					
28	Capital Structure (inclusive of AIAC and Net CIAC)				
29					
30	Short-term Debt		0 0.0%	94,078	5.5%
31					
32	Long-term Debt		0 0.0%	205,922	12.1%
33					
34	Common Equity		41,575 9.9%	1,023,275	60.1%
35					
36	Advances in Aid of Construction ("AIAC")		12,057 2.9%	12,057	0.7%
37					
38	Contributions in Aid of Construction ("CIAC") ⁵		366,576 87.2%	366,576	21.5%
39					
40	Total Capital (Inclusive of AIAC and CIAC)	\$	420,208 100.0%	\$ 1,701,908	100.0%
41					
42					
43	AIAC and CIAC Funding Ratio ⁶		90.1%		22.2%
44	(36+38)/(40)				

¹ Column [A] is based on 2006 financial information for the year ended December 31, 2006.

² Column [B] is Column [A] modified to reflect a \$300,000 loan, at an interest rate of 6 percent, for 3 years. Column [B] also modifies Column [A] to reflect paid-in-capital investment of \$981,700.

³ Not Meaningful

⁴ Pro Forma Short-term Debt represents the annual principal portion of the proposed loan.

⁵ Net CIAC balance (i.e. less: amortization of contributions).

⁶ Staff typically recommends that combined AIAC and Net CIAC funding not exceed 30 percent of total capital, inclusive of AIAC and Net CIAC, for private and investor owned utilities.

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Director Utilities

FENNEMORE CRAIG, P.C.
 Jay L. Shapiro (No. 014650)
 Patrick J. Black (No. 017141)
 3003 North Central Avenue, Suite 2600
 Phoenix, Arizona 85012
 Telephone (602)916-5000
 Attorneys for Pine Water Company

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
 OF PINE WATER COMPANY FOR
 APPROVAL TO (1) ENCUMBER A PART
 OF ITS PLANT AND SYSTEM
 PURSUANT TO A.R.S. § 40-285(A); AND
 (2) ISSUE EVIDENCE OF
 INDEBTEDNESS PURSUANT TO A.R.S.
 § 40-302(A).

DOCKET NO: W-03512A-07-0362

NOTICE OF FILING CERTIFICATION
OF PUBLICATION

At Staff's request, Pine Water Company ("PWCo") had published legal public notice regarding PWCo's Application for Approval to (1) Encumber a Part of Its Plant and System Pursuant to A.R.S. §40-285(A); and (2) Issue Evidence of Indebtedness Pursuant to A.R.S. §40-302(A). Accordingly, PWCo hereby submits this Notice of Filing Certification of Publication in the above-captioned matter.

On July 17, 2007 legal public notice was published in the *Payson Roundup*. The affidavit of Eve Paludan, Assistant Bookkeeper of the *Payson Roundup*, is attached hereto as Exhibit A.

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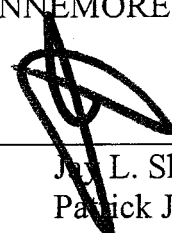
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DATED this 2 day of August, 2007.

FENNEMORE CRAIG, P.C.

By



J. L. Shapiro
Patrick J. Black
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012
Attorneys for Pine Water Company

ORIGINAL and thirteen (13) copies of the foregoing filed this 2 day of August, 2007:

Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

COPY of the foregoing hand-delivered this 2 day of August, 2007:

Mr. Kevin Torrey, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

By: maria san jose

1944825.1/75206.015

EXHIBIT

A

Affidavit of Publication

Payson Roundup

10020794

STATE OF ARIZONA

7/17/2007

COUNTY OF GILA

I, Eve Paludan, do solemnly swear that I am Assistant Bookkeeper of the Payson Roundup, that the same is a newspaper printed, in whole or in part, and published in the COUNTY OF GILA, State of Arizona, and has a general circulation therein; that said newspaper has been published continuously and uninterruptedly in said COUNTY OF GILA for a period of more than fifty-two weeks prior to the first publication of the annexed legal notice or advertisement; that said newspaper has been admitted to the United States mails as second-class matter under the provisions of the Act of March 3, 1879, or any amendments thereof, and that said newspaper is a newspaper duly qualified for publishing legal notices and advertisements within the meaning of the laws of the State of Arizona. That the annexed legal notice or advertisement was published in the regular and entire issue of every number of said daily newspaper for the period of 1 consecutive insertions; and that the first publication of said notice was in the issue of said newspaper dated July 17 A.D., 2007, and that the last publication of said notice was in the issue of said newspaper dated July 17 A.D., 2007. In witness whereof I have hereunto set my hand this July 17 A.D., 2007.

Eve Paludan

Eve Paludan

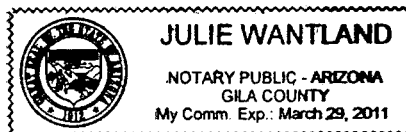
Subscribed and sworn to before me, a Notary Public in and for the COUNTY OF GILA, State of Arizona July 17 A.D., 2007.

Julie Wantland

Julie Wantland, Notary Public

My commission expires March 29, 2011.

2011.



11068
11068: 7/17/2007
PUBLIC NOTICE OF AN APPLICATION SEEKING APPROVAL TO ENCUMBER A PART OF ITS PLANT AND SYSTEM PURSUANT TO A.R.S. § 40-285(A) AND TO ISSUE EVIDENCE OF INDEBTEDNESS PURSUANT TO A.R.S. § 40-302(A) BY PINE WATER COMPANY

On June 11, 2007, Pine Water Company filed an Application with the Arizona Corporation Commission (Commission) for approval to authorize approval to encumber a part of its plant and system pursuant to A.R.S. § 40-285(A) and issue evidence of indebtedness pursuant to A.R.S. § 40-302(A). Pine Water Company is not seeking adjustments to its rates and charges for water and sewer utility service in the financing application.

The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices at 1010 S. Stover, Payson, Arizona 85541. Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
 2. A short statement of the proposed intervenor's interest in the proceeding.
 3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
 4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.
- The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.